

2003

Economics GA 3: Written examination

GENERAL COMMENTS

Teachers should note that the comments made in this report are based on the Economics Study Design, 2000–2003. A recredited study design has been implemented in 2004. Importantly the 2004 examination will be changed to a question and answer book format.

It has been very exciting to witness the growth in the knowledge and confidence of students tackling the economics examination. Most students attempt all questions and some very sophisticated answers are seen. While time management is improving, some students need to write more concise answers to short (2 mark) questions and provide more detailed and complex responses to longer (6 and 8 mark) questions.

Use of abbreviations and point form in Section B is not good practice. It is acceptable to use point form [perhaps] in the last part of the last question if you are running out of time but it is not acceptable to do this in other questions for Section B. Students may also use commonly accepted economics abbreviation like GDP or CAD but it is good practice to write this out once and then show the abbreviation you are using. It is not acceptable to use arrows to indicate an increase or decrease when answering questions in Section B.

Students with knowledge of current, and recent, Australian economy performance and management score high marks. It is really important that students take examples of recent economic events and think about how these are likely to impact on the performance of the Australian economy in terms of economic objectives and the management of the Australian economy in terms of policies. In 2003, issues on the agenda included the drought, surging consumer spending, a relatively weak world economy, issues about economic security; and these were all ideas and examples that were assessed in the examination or that could be used to illustrate economic theory.

Students need to be careful not to overdo definitions. Definitions when used should address the key economic concept that the question is asking about. Definitions should be concise and cover the essential economic idea. In this examination, for example, some students wasted valuable time defining the term drought in Question 2. This was not the essential economic idea and therefore was time wasted. However, when a question is worth 8 marks and students are trying to find a ‘way in’ to answering the question, definitions can sometimes provide a framework for tackling the ‘big ideas’ of the question. For example, in Question 3c starting out defining domestic economic stability and monetary and microeconomic reform policy provided such a framework.

Section A – Multiple choice

This table indicates the approximate percentage of students choosing each distractor. The correct answer is the shaded alternative.

Question	A	B	C	D
1	2	80	14	4
2	7	10	75	8
3	52	14	14	20
4	51	11	32	6
5	2	1	91	6
6	21	6	52	21
7	72	12	1	15
8	33	14	10	43
9	1	82	7	10
10	11	2	22	65
11	90	6	3	1
12	15	71	8	6
13	5	5	80	10
14	16	18	14	52
15	9	7	79	5

Section B

Question 1

ai

Marks	0	1	2	Average
%	26	21	53	1.27

aii

Marks	0	1	2	Average
%	35	22	43	1.08

ai–ii

Many students did not relate the idea of cyclical and structural to the budget; writing instead about cyclical and structural unemployment. Some students also confused monetary policy and changes in interest rates as part of discretionary budgetary policy. Students as part of their revision strategy for the examination should be able to explain key economic concepts so that they are able to capitalise on questions such as Question 1a.

Students should think carefully about the requirements of 2-mark questions. It is useful to remember to keep explanations and examples concise, and not be tempted to write lengthy and detailed explanations, giving a number of examples. One example for each of cyclical and structural was all the question asked. Some students spent too much time on this question and then found it difficult to complete the paper. A good answer explaining cyclical factors stated that budget revenues and budget spending/expenditures automatically rise and fall over the course of the business cycle as the business cycle affects budget outcomes. Students then chose one of these examples: example 1 – if the economy is experiencing recession, tax revenues fall as the level of economic activity slows and the income base is reduced while government spending on welfare rises as more people are unemployed; or example 2 – if the economy is experiencing strong economic growth and boom conditions, tax revenues will rise as more people are working and business performance is strong as the income base is increased while government spending on welfare falls as less people are unemployed.

A good answer explaining structural factors outlined that budget revenues and/or budget expenditures can move as the result of discretionary/deliberate policy action/change by the government and then provided one of the following examples, the government – lowers personal income tax rates; raises the level of the GST; increases expenditure on the provision of infrastructure to upgrade the road and rail transport system.

bi

Marks	0	1	2	Average
%	34	23	43	1.08

bii

Marks	0	1	2	3	4	Average
%	9	12	25	23	31	2.53

bi–ii

Students were not sure about the difference between progressive and regressive systems of taxation. Many responses stated taxes levied on commodities such as alcohol and tobacco are progressive, and did not talk about tax as a percentage of income. Successful answers explained that taxes levied on commodities such as alcoholic beverages and tobacco products are considered to have a regressive effect as consumers on lower incomes spend a disproportionately large share of their income on the purchase of these commodities and demand is unlikely to change even if price increases.

Most students were able to outline two economic reasons why governments levy taxes. The most frequent reasons outlined by students included that the government levied taxes:

- to raise revenue to fund expenditure such as to provide public goods
- to affect the distribution of income such as to improve equity through the levying of progressive personal income taxes
- to affect the allocation of resources such as to reduce negative externalities by levying environmental taxes
- to provide macroeconomic stabilisation (counter-cyclical fiscal policy) such as in a recession in order to stimulate spending and economic growth, reduce personal income taxes and company taxes.

c

Marks	0	1	2	3	4	5	6	Average
%	18	10	13	16	18	13	12	2.92

Students are expected to have a good understanding of current economic conditions and policies in the Australian economy. There are often a number of questions where students can ‘show-off’ their current knowledge of economic activity and management in the Australian economy. This question provided such an opportunity. There were some excellent answers to this question with some of the following influences on budgetary/fiscal settings outlined

- revenues forecast to rise by 2.9% – could be attributed to more workers in higher tax brackets – ‘fiscal drag’ (average weekly earnings now at \$52 000 where marginal tax rate goes from 30% to 42%) even though small personal income tax cuts were to be introduced
- spending forecast to rise by 4% – increased defence spending including spending as a result of the war on terrorism and ‘homeland’ security; on-going drought assistance; more resources allocated to higher education
- political influences – for example, the personal income tax cut was very small but an important symbolic political message that now the government has virtually paid off all public debt and that the budget was returned to surplus, the government could afford the tax cut and return something to wage and salary earners. Also, the small cut was considered appropriate considering the forecast slowing in economic growth as it will be mildly stimulatory
- commitment to governments’ medium-term fiscal strategy – to maintain budget balance, on average, over the course of the economic cycle – maintaining budget surpluses while economic growth prospects remain sound, no increase in the overall tax burden and improving the Commonwealth’s net worth position
- commitment to improving efficiency – many economists believe replacing general-taxpayer funding with cost-related user charges should encourage greater technical and allocative efficiency by increasing the role of market forces. For example, although government will increase funding to higher education sector, it will also allow individual universities to increase their HECS fees by up to 30 per cent and allow more locals to be admitted to particularly competitive courses as full fee-paying students. Changes to Medicare will also see greater reliance on user charges. Reduced access to bulk-billing by everyone other than pensioners and other concession card holders will mean more people must make the co-payment when visiting the doctor.

di

Marks	0	1	2	3	Average
%	35	19	21	25	1.36

dii

Marks	0	1	2	3	Average
%	46	25	18	11	0.93

di–ii

This question required students to apply their current (specifically over the last 2–3 years; the question stated 2001–03) knowledge of budgetary/fiscal policy to the management of the Australian economy. While part i was done better than ii it is of concern that many students were unable to talk about how policy works to impact on two key areas of management in the economy, that is, external stability and efficiency. Some students got into trouble by not choosing a specific area of budgetary/fiscal policy (such as changes in personal income tax rates) and applying this to the achievement of external stability or efficiency (they explain budgetary policy in general, that is whether it has been expansionary or contractionary). Some of the most successful answers for 1di explained how one of the following budgetary policy outcomes impacted on external stability.

Note: the explanation for external stability could mean any aspect of budgetary policy that has had an influence on the current account deficit – CAD, net foreign debt – NFD and/or the exchange rate outcomes and/or influences international competitiveness in a positive or negative way.

- budget surpluses have meant that the government has reduced the need for overseas borrowings – therefore the current account deficit of the balance of payments reflects private sector savings and investment decisions
- budget surpluses have been applied to pay back government debt and therefore is less need for overseas borrowings which improves levels of Net Foreign Debt
- budget surpluses facilitate a lower interest rate environment, which promotes a weaker currency, increasing Australia’s international competitiveness
- income tax cuts means consumers have more disposable income which may see demand for imports increase thus increasing the CAD
- lower company tax means the costs of production are lowered for businesses which should improve international competitiveness.

Students had more difficulty selecting an aspect of budgetary policy that has influenced efficiency in resource allocation. However, the most successful answers talked about how some of the following changes in government spending and taxation decisions impacted on efficiency of resource allocation:

- increased funding for road and rail transport, improving infrastructure, lower transportation costs, increasing efficiency
- continuation of privatisation
- additional funding directed to the war on terrorism and border protection
- additional funding to assist those in drought and bushfire affected areas
- targeted assistance such as extra subsidy for the first home buyers grant.

Question 2

The drought has been an important topic in Australia over the last couple of years and is clearly a factor that has a significant economic impact. This question highlights the importance for students to develop their understanding of important economic relationships, including the relationships between factors affecting the performance and management of the Australian economy.

a

Marks	0	1	2	3	4	Average
%	3	13	27	31	26	2.64

Most students managed this question satisfactorily. They needed to explain a couple of ways the drought is likely to reduce economic growth. The most successful answers made a distinction between the likely direct and indirect impact. For example, directly – rural production is a significant component of GDP so economic growth would be lower as a result as there would be less rural production; reduced supply of rural produce on international markets is likely to lead to a fall in exports. Indirectly – a fall in rural incomes reduces the demand for consumer goods (and capital goods) normally purchased by rural residents. This has significant flow-on (multiplier effects), lowering the incomes of suppliers who supply the consumer and capital goods to rural residents. Therefore, the demand for goods and services is also reduced in this way, thus reducing economic growth.

bi

Marks	0	1	2	Average
%	16	24	60	1.44

bii

Marks	0	1	2	Average
%	19	25	56	1.37

bi–ii

Generally, students handled part (b) well. There has been an improved understanding by students over the last couple of years in the area of external stability. The most successful answers explained that as rural goods are a large part of Australia's exports, it is likely that there will be a fall in export receipts (assuming that the percentage decrease in quantity sold exceeds the percentage increase in prices) leading to a larger balance on merchandise trade deficit and therefore larger balance of payments on CAD. And in part (ii) this means a reduction in the relative demand for Australian currency (overseas residents need fewer Australian dollars since their expenditure on Australian exports is reduced). This is likely to put downward pressure on the value of the Australian dollar leading to depreciation.

ci

Marks	0	1	2	Average
%	21	28	51	1.30

Most students were able to say that the likely shortages of rural produce (for example, meat) will lead to the prices of these goods being bid upwards (and any industry that uses rural output as an intermediate good will also probably charge higher prices – for example, flour for bread production), hence a drought could be inflationary. This could be modified/offset if reduced demand flowing from lower rural incomes leads to a fall in aggregate demand and slower economic growth.

cii

Marks	0	1	2	Average
%	23	29	48	1.25

ci–ii

Part 2c was more difficult with some students using incorrect economic reasoning. Many students made assertions and did not explain why they had drawn these conclusions. Others thought that higher prices automatically change income distribution. Students were expected to acknowledge that the rural sector relative to the non-rural sector will have their incomes decreased during the duration of the drought. It is more likely that we will observe higher unemployment in the rural sector that is likely to cause a widening in income distribution.

d

Marks	0	1	2	3	4	5	6	Average
%	17	10	14	20	18	12	9	2.81

Students found this question rather challenging. It is important to discuss current economic issues and to think 'about how these economic issues impact on the performance of the Australian economy' and 'how these issues can be managed using economic policies'. It is also important to think carefully about whether issues need to be managed in the short term or longer term. If an issue needs to be managed in the short term, as in the case of the drought then it is unlikely that microeconomic reform policy will be effective. The results of these policies work better in the medium to longer term. Students therefore should turn their attention to how we best manage the concerns discussed above – how do policymakers avoid the fallout associated with reduced economic growth, reduced rural exports, reduced rural incomes etc. We could expect the main aim of the application of government policies would be to avoid closure of rural and associated businesses and the associated unemployment that would result, as well as to avoid the implications for domestic and export production, to provide income assistance in the short term and to support producers next harvest/restocking, once the drought breaks.

The most successful answers suggested two of the following policies and went on to explain how this policy would assist in alleviating the economic effects of the drought:

- increase government spending in budget to provide income support/cash subsidies through, for example, Centrelink for those rural producers meeting rainfall deficiency criteria
- increase government spending in budget to subsidise costs involved in re-stocking, buying seed
- increase government spending in budget to provide tax relief such as allowing rural producers an extension of time to pay and/or offer an interest free installment plan to pay tax off
- interest rate relief and/or low interest loans made available to rural producers
- institute short term public works programs to employ rural unemployed
- tax incentives for installation of drought management procedures.

Question 3

a

Marks	0	1	2	3	4	5	6	Average
%	17	16	18	18	15	9	7	2.49

The scenario of a weakening in world economic growth and increased growth in domestic spending reflected what the Australian economy experienced during late 2002 and through 2003. Students needed to:

- consider how each factor is likely to impact on the level of economic growth and price stability
- recognise that the two factors would have different effects.

A weakening in world economic growth is likely to reduce demand for Australian exports leading to a fall in aggregate demand. This would exert downward pressure on inflation. This may cause inflation to fall below the target of 2–3% per annum on average over the business cycle, though of itself a fall in aggregate demand may be reason enough for the Reserve Bank of Australia to respond. Therefore, monetary policy settings may be eased/become expansionary (a lowering of the cash interest rate flowing on to lower interest rates generally) in order to:

- provide an incentive for increased firm's investment expenditure and consumer spending to support demand
- lower demand for Australian currency (as interest rates are lower which leads to less capital inflow) which would lead to increased international competitiveness.

However, increased growth in domestic spending (perhaps fuelled by cuts in personal income taxes, lower levels of unemployment, surging consumer confidence on the back of strong growth in the value of housing property) may cause aggregate demand pressures to occur thus causing a rise in inflationary pressures. If the RBA considered this inflation may possibly push above their target rate of 2–3%, then it is likely they would respond by tightening monetary policy (increasing the cash interest rate) in the hope of slowing C and aggregate demand.

So on balance, it may be that there is no change to monetary policy settings as each factor cancels out/offsets the effect of the other. In fact, no change to interest rates and to monetary policy settings was exactly what occurred in Australia between June 2002 till November 2003 as this scenario was the one faced by the Reserve Bank. Clearly for students to achieve full marks on this question they needed to recognise that the two factors had the opposite influence.

bi

Marks	0	1	2	3	Average
%	26	12	23	39	1.74

bii

Marks	0	1	2	3	Average
%	37	18	18	27	1.35

bi-ii

Most students understood that an expansionary monetary policy is one where the cash interest rate is lowered (and/or stays low), flowing through to lower general interest rates. The best answers went on to explain that the likely effects of expansionary monetary policy is stronger aggregate demand as low interest rates provides incentives for consumers [C] and producers [I] to spend and borrow because credit is relatively cheap. Stronger aggregate demand will see an increase in economic growth and a fall in unemployment. Students who understood these links usually made the following points about the impact on:

Price Stability – that as the economy approaches full employment, there is a tendency for upward pressure on the rate of inflation. For example, some key sectors may reach capacity before others or workers might push for higher wages on the back of strong economic growth. With few unemployed resources, as demand rises, prices are forced up. This means full employment might be achieved but with unacceptably high rates of inflation. So an expansionary monetary policy may eventually have a detrimental impact on price stability.

External Stability – might be compromised if the higher incomes produced by the improved employment outcomes associated with stronger economic growth and the lower interest rates causes a rise in the demand for imports.

c

Marks	0	1	2	3	4	5	6	7	8	Average
%	23	12	12	13	11	11	9	6	3	2.93

It was clear that in a large number of cases students had either left insufficient time to develop a detailed enough answer for an 8-mark question or did not understand the term 'evaluate'. Evaluate means to weigh up/judge/assess by examining arguments for and against. In this question students were asked to judge the extent to which microeconomic reform policy has supported monetary policy in the pursuit of domestic economic stability in Australia over the last decade. Many students received low marks because they did not understand the requirements of the question and tended to talk about one policy and/or to ignore the meaning of domestic economic stability. Students are advised to read questions carefully and make sure they attempt all parts. The most successful answers realised this question was about 'policy mix' and established a framework for answering by discussing the meaning of monetary and microeconomic reform policies and outlining what the pursuit of domestic economic stability is all about, that is relatively strong economic growth, price stability and full employment.

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Published by the Victorian Curriculum and Assessment Authority
41 St Andrews Place, East Melbourne 3002

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